Gold-gold matters

Does the Comex gold trade in a vacuum? What the gold miners can learn from Glencore…..

So: gold is taken down by 10% over the last two months — 5% of that in two short minutes — and is headed lower yet, apparently, because a) interest rates are going up and b) the metal didn't "perform" when it should have, namely, during the Greek crisis. Market sentiment has followed suit with popular media piling on: "Why Gold Doesn't Matter", "It's Time to Surrender", and, best of all: "Let's be Honest about Gold: It's a Pet Rock", headlines that put shame to the FT piece back in the late '90's: "The Death of Gold". Spec short interest is at the highest since 2000. It is pretty much the end of the world. Again.

We suspect these pundits would have felt much the same way if the starting point of the most recent downdraft had been \$2000/0z, \$1500/oz, \$1000/oz, \$500/oz or the price of Pet Rock at the corner store. Put differently, gold trades in a vacuum where the right price is whatever the price is now, plus or minus fifty dollars. Unlike copper or potash or met coal, governed as these are by the tyranny of supply and demand, price discovery in gold amounts to an arm wrestling contest over which way the wind is blowing.

The bearish analysts on the Street are calling for a sub-\$1000 bottom. If gold is unmoored to any underlying then why stop there? Why can't it trade at \$800? Why can't it trade at \$400? The industry was arguably cash flow negative, (at least on a sustainable basis), at the highs of the last cycle. But if the paper market solely determines pricing, then what's to stop gold from going to the lows of last decade?

The enabling philosophy that allows gold to trade "wherever it likes" is the stocks model of price formation, a model that holds that gold should be priced as a function of total gold surface stocks – "all the gold that has ever been mined." In this context, mine production and scrap flows don't matter because, if you are bearish, who doesn't like near-infinite supply? Supply such that supply doesn't matter? And for some bulls, the stocks model also aligns well with preconceptions, in this case, with fine monetary theory. If gold is money, then gold should be priced like money and money is priced as a function of M1, M2, etc. – total monetary stock. The stocks model keeps everyone happy, it seems.

We would agree that this is how gold trades most of the time, buffeted about by Fed rumours and BLS data and stop hunting, oblivious to any absolute reference frame a gold producer or other participant in the physical market

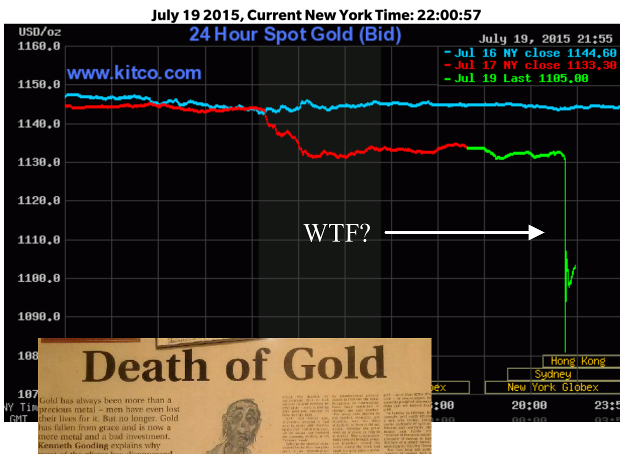

***Figure 1:** On a quiet Sunday night this past July someone saw fit to sell, on no apparent news, contracts representing 700,000 ounces of gold in a matter of seconds. Gold producers and investors were sent reeling — once again the paper tail wagging the bullion dog. As it was, a gold price in the \$1200's has rendered most of the industry uneconomic. Are there no constraints in the world of paper gold? Soon thereafter came reports of gold's demise, including a comparison to a pet rock. The headline here is from the FT in the late 1990's.*

would recognize. John Hathaway put it well when he quipped that what gets traded day-in and day-out is not so much gold but rather the "idea of gold" – that's a great expression. Most of the time this is correct, gold trades like a macroeconomic weathercock.

We feel this is true but only to a point. There is evidence to suggest that when "the idea of gold" is getting pummelled on the futures markets every now and then, but increasingly of late, the economics of the physical market makes an appearance. And when this happens, gold tends to trade higher. We feel gold, that is, "gold-gold", not paper gold or the idea of gold, but rather the kind of gold that hurts when you drop it on your foot, that this does matter. We also feel that given recent trends in the data it will matter more going forward.

Physical scarcity of metal has a long history driving the market higher, from Buffet's purchase of silver in the late 1990's to the hedgebook squeeze early the next decade to the book squaring rally after Lehman went down. The best way to measure physical scarcity is via the London term structure or swap market (these terms are interchangeable); when spot gold tends to trade up on gold for delivery for one or three or six months out, we can say that the physical market is tight. When, in absolute terms, spot gold trades higher than the futures, the market is said to be in backwardation. We have written about this elsewhere, but if there is any unen-

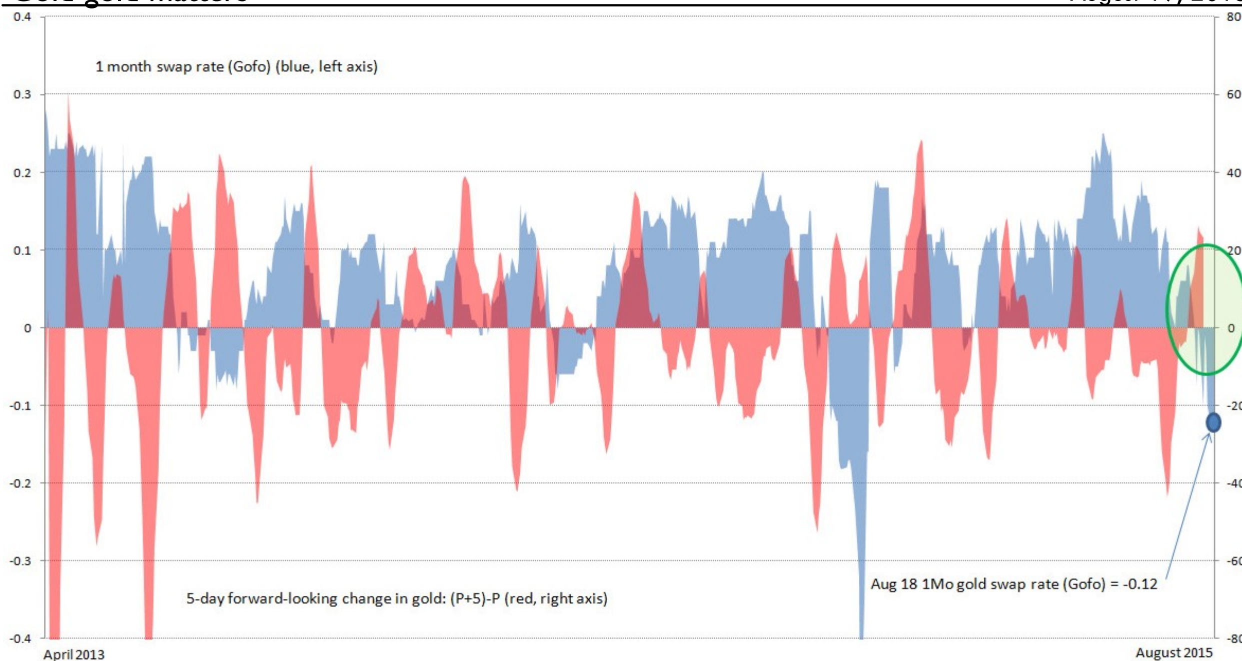

Figure 2: *For a period spanning April 2013 to the present (that is, post-crash) we show the five day change in gold price in red and the one-month swap rate (aka "Gofo") in blue. The swap rate measures the relative preference of physical gold over paper gold. The lower the rate, the greater the preference for physical. When the rate is negative one would say the term structure is in backwardation. If you squint you can see the symmetry between these two plots, which is to say that gold tends to rise when physical is preferred. This tells us scarcity of the metal acts as a constraint to the paper market and that the float for gold is less than everyone thinks. It also puts lie to the pernicious "stocks" model of gold price formation. Note that gold is once again in backwardation. This bodes well for near-term price action.*

cumbered or "surplus" gold hanging around, it makes sense to sell that gold into the tight spot market and contract to buy it back later. If this arb does not come in, it can *only* mean that this "surplus" gold does not exist within the realm of the wholesale bar market.

See figure 2 for a plot of the 1Mo swap rate vs. the five day change in gold price. When the term structure approaches or enters into backwardation, as evidenced by the blue line being near or beneath zero, the change in gold price (red) tends to be positive. The two plots are by no means a mirror image of each other, but if you squint you can see the symmetry. We quantify this more clinically in figure 3 where we show the 5-day returns of the London fix as a function of the 1Mo swap rate. Here it is easier to see that the more the term structure inverts, the higher gold trades over the short term.

This speaks to a two-phase market: above a certain price (which is most of the time) gold trades as "an idea", but beneath this price it trades as a physical commodity. To be poncy, we see an analogy here with fluid flow, which can either be laminar or turbulent. Laminar flow seems akin to the physical trade: languid, predictable, and fairly stable. We looked up the Wikipedia entry for 'turbulent flow' and got this: "[D]ominated by inertial forces, which tend to produce chaotic eddies, vortices and other instabilities." See figure 4, where we show the boundary of these two phases or pricing models. Clearly, at least over the last two years, the physical market has acted as a brake on the "inertial forces" of the paper market.

The data also puts lie to the "stocks model" of gold price discovery. If there were "infinite supplies" or "all the gold that has ever been mined" just laying there on the top ring of the pit with a for sale sign on it, gold would *never* go into backwardation and, moreover, gold wouldn't, according to the theory, care if it did. We understand the appeal of the stocks model, but the data simply does not support the theory, even as some folks would like it to be otherwise. Rather, the data suggests that when the flow of stocks to market runs dry, the price reacts in upward fashion. Which is to say that gold, when traded as a metal, reacts like any other commodity.

Instead of "stocks" we should be thinking in terms of "float". By this we mean that fraction of "stocks" which is for sale within some margin of recent prices. Everything has a "float". We are all familiar with the concept. The data suggests that the float on gold is less than habit would note and that yes, it matters.

This has implications for producers. Imagine if Glencore and/or Trafigura operated in the gold space? Why do these trading groups covet off-take agreements and control of the physical as they do? What

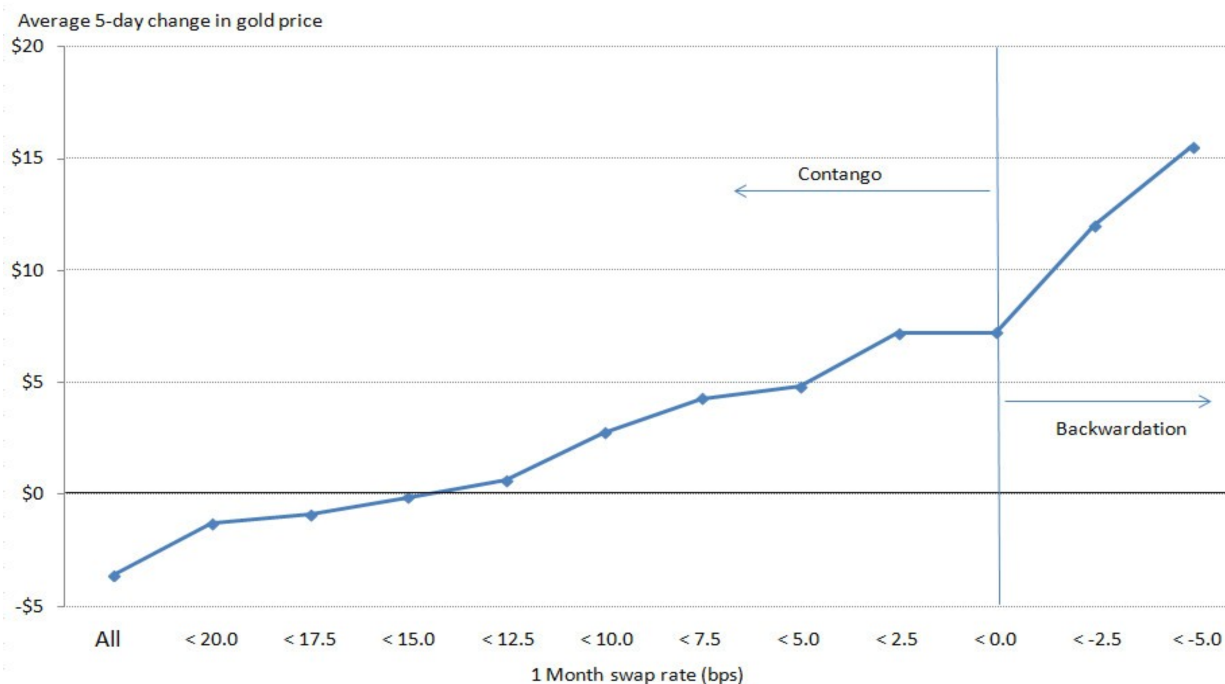

Figure 3: *In figure 1 we showed how gold tends to rise as the term structure tends to inversion. Here, we measure it. This plot shows average five day returns as a function of the swap rate. The first data point is the average five day return since April, 2013. The second point is the average five day return on days when the swap rate was 20bps or less. Etc. As the swap rate declines, the returns increase. And note the inflection point at 0.0 bps — that is, note how when physical trades up on the 1Mo contract this trend accelerates. Clearly, gold-gold matters.*

do they see in them? Suppose they had a lock on gold flows as they do base metal flows -- would the gold price be higher or lower? Gold mining companies might do well to think a little more like these trading companies, for in terms of their ability to direct-market their product, it is our view that they have more clout than they may know.

At the time of writing, gold-gold remains back in favour, and this after a $30 bounce from the lows. The 1Mo swap rate is = -0.12. This corresponds well with reports of elevated physical demand in the form of both retail small bars and central bank large bars, and this all is net of vaunted ETF outflows. Such conditions are unusual, for a rise in notional prices usually provides relief to the physical market. Given the extreme negative sentiment now prevalent, the large paper short position, this appears to be a very bullish set-up.

Even as we feel gold would trade much higher if it were to trade as a commodity governed by long term supply-demand balances, this is not to say we don't see prospects for the paper gold market as being favourable. The Chinese devaluation underscores the one-trick-pony nature of central banks. There will be more here as that massive credit bubble resolves itself and, in a fiat environment, credit bubbles resolve themselves in one way and one way only. This in turn will inform the Fed that they are not an Island unto themselves, as much as they would like to believe otherwise. There may be a token rate hike, if only to give the central planners something to give back, but there will nothing here on any sort of a sustained basis. The ephemeral wealth that has been be created by a 35-year decline in interest rates will not be taken away. Paper gold and related products have also suffered from "performance anxiety." With general equity market internals disintegrating, we expect relief here too. There is every reason to be bullish on paper gold.

But we feel there is a lot less gold-gold out there than common thought would have it. Consider that the gold mining industry has run a primary deficit for years and, one way or another, and certainly not in a straight line, this will have had the effect of slowly sapping surface stocks, of mobilizing metal from weak hands to strong. Our time frame here would be two decades or more. The float today is surely substantially less than what it was the last time The Death of Gold was proclaimed.

That said, given the opacity of the bullion market it is

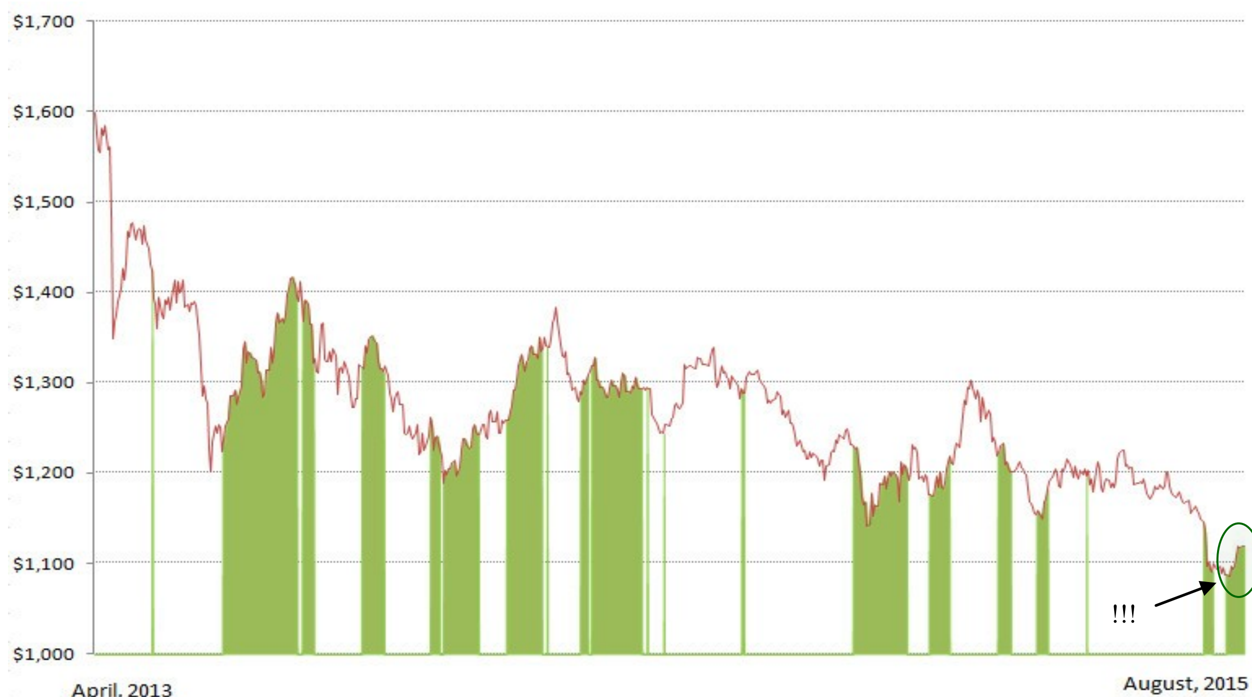

***Figure 4:** Shown here is the gold price since April, 2013. The green areas are periods when the swap rate was less than 8bps. From this perspective, the role of physical scarcity can be clearly seen to act as a break on the downward price pressure. And the frequency with which the term structure tightens — this is a new development — suggests that the float on gold is a lot less than people think. Also note the current swap rate of –13bps; in conjunction with the large spec short position, the conditions for a sharp rally here seem opportune.*

difficult to measure with any precision how much float is left. But since Lehman crisis in 2008 the term structure has been notably tight. And since the crash of 2013 the market has traded near or in backwardation half a dozen times. Then late last year the 1Mo swap rate fell down to -0.40 bps, a period of extreme dislocation that lasted close to a month, only to be (mysteriously?) quenched overnight. Comex warehouse stocks are likewise showing signs of periodic stress/depletion only to be likewise quenched overnight. You get the sense that the liquidity conditions in the bullion market may not be that different from the parched liquidity conditions amongst the juniors, both passing the hat to friends and family to get through the day, as it were.

If the surface float is less than we think it is, then in-ground stocks, (otherwise known as reserves), are also showing signs of depletion. On the cusp of the last boom, the reserves of senior producers', as measured in years of mine life, would be ballpark twice what they are today. And moreover these stocks here have been shown to be highly inelastic – tens upon tens of billions of exogenous capital poured into the sector and very, very little was found. Unlike the frackers or, say, the zinc industry, a rally in gold will not see more metal get coughed up from the primary producers; indeed, gold production will almost certainly fall for the next twenty years no matter what the gold price does.

Investors in gold equities can gnash their teeth at the shenanigans on the Comex, and that's fair enough. The current price makes no sense at all in terms of gold-gold economics. It should nonetheless be borne in mind that the last boom was largely a paper gold boom, where punters, suffuse with visions of geopolitical and monetary overreach, piled willy-nilly into long positions. The next boom, however, if the float is as thin as we think it is, may well be driven by physical scarcity, something a gold exploration geologist knows something about, be they in the jungle or on the tundra.

Let paper gold go dance upon that.

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